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C O N F I D E N T I A L SECTION 01 OF 02 DUBLIN 000146

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TREASURY FOR ATUKORALA

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TAGS: ECON EFIN PREL EI
SUBJECT: THE IRISH GOVERNMENT'S APRIL BUDGET: BEGINNING OF A LONG JOURNEY

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Classified By: Pol/Econ Section Chief Ted Pierce. Reasons 1.4(b/d).

¶1. (C) Summary: On April 7 the Irish government will release a new budget aimed at fixing the hole in government finances and in its reputation. Even with the new measures, the government's 2009 fiscal deficit will come in above the 9.5 percent that it forecast earlier in the year. Most economists recommend that the government focus on spending cuts for fear that tax increases may choke off any hope of near-term economic recovery. Such a focus risks angering a sizable minority of the electorate who are now dependent on social welfare payments. This budget is the first step toward putting Ireland's economic house in order and, depending on its harshness, is likely to cause political problems for the government. End Summary.

Time For The First Step

¶2. (C) With the unveiling of new budget measures on April 7 the Fianna Fail-led government hopes to begin rebuilding Ireland's image as a predictable, stable place to do business and, at the same time, show the Irish electorate that it has the wherewithal to lead Ireland out of the current economic crisis. The media, the political cognoscenti, and, increasingly, the "man on the street" have complained about the government's piece-meal, equivocating approach to tackling the crisis over the past nine months. In order to do this, the government looks set to enact measures that will cut the government's budget deficit by several billion dollars. Nevertheless, even with this action, the 2009 deficit looks likely to reach double digits as a percentage of GDP -- above the 9.5 percent the government predicted in January 2009.

¶3. (U) On March 30, Prime Minister Brian Cowen indicated that tax revenues may be Euro 2 billion (USD 2.9 billion) less than the government predicted just a week previous, dropping from Euro 34 billion (USD 49 billion) to Euro 32 billion (USD 46 billion). This comment came on the heels of the latest grim economic news that output in Q4 2008 fell by 7.5 percent, year-on-year. Spending on machinery and equipment led the way, falling by a staggering 48 percent. In all, domestic demand dropped 10.6 percent. Recently, Cowen started to highlight that the April 7 budget will only be the first of five year's worth of deficit-fighting budgets and that the "structural" portion of the deficit (i.e. the permanent loss of tax revenues as a result of a change in the pattern of economic activity in Ireland) may be eight percent of GDP.

¶4. (C) Dan Boyle, member of the Irish Senate and Green Party chairman and economic spokesman, told Emboffs that tax increases would likely account for two-thirds of the deficit-reduction plan for this year. (Note: The Green Party is the junior partner in the ruling government coalition. End Note) He noted the political difficulties of tackling the spending side of the government accounts, especially given that one-third of spending goes to social welfare programs. Boyle said that the Green Party supports means-testing or taxation on social welfare benefits but did not indicate whether the government would propose such measures. He said that the next budget would take place in December 2009 and that it would include recommendations from government-appointed bodies looking at how to improve the tax code and where to cut spending.

The Opposition's Take

¶5. (C) On April 1, Fine Gael, the main opposition party, presented their analysis of the budget, recommending a Euro 3.5 billion (USD 5 billion) combination of spending cuts and tax increases. Andrew McDowell, Fine Gael's economic adviser, told Emboffs that any more than this will "cripple the Irish economy." He said that, among other measures, Fine Gael recommended that the government should raise taxes on top earners, lower VAT rates temporarily, and cut both staffing levels and pay in the public sector. He said that Finance Minister Brian Lenihan's conspicuous efforts to include opposition parties in a budget solution were just "political gamesmanship." Lenihan wants to be able to share the blame following the upcoming draconian budget. McDowell said the budget will be "savage" and "harsh" and that "political hostilities will resume on budget day."

¶6. (C) According to McDowell, the government will have little choice but to cut social welfare spending. He noted that this is politically risky because those who receive these benefits tend to be lower- or middle-class workers who have lost their job and are saddled with significant debt. To be seen as taking money out of their pockets versus going after the bankers and property developers (who are popularly viewed as the real villains in this drama) will not play well with the voting public. McDowell agreed that Ireland is at a crossroads and that the country needs to decide whether it wants a "European-style social welfare system or a low-tax system." He said both were undertaken during the days of the Celtic Tiger but this was no longer a sustainable model.

OK, Maybe It Won't Be 9.5 Percent

¶7. (C) Pat McArdle, Ulster Bank chief economist, told Emboff that his latest forecast of a fall in Ireland's GDP of eight percent looked optimistic based on the latest data. He indicted it may fall nine percent depending on what the budget looks like and wrote in a recent op-ed that a "double-digit contraction could now be in the cards." McArdle argued that if the government were to stick to the pledge it made to EU officials to keep the budget deficit at 9.5 percent of GDP, such a budget "would finish an economy which is already on its knees." Instead, he recommended that the government should aim to come in at a deficit of about 12 percent but warned that the budget should consist primarily of spending cuts.

¶8. (C) Jim Power, chief economist at Friends First, told Econoff that he expects a &stark and dramatic8 budget. He agreed with McArdle that the government needs to focus on the spending side and pointed to a pay freeze in the public sector as the way to go about doing it. Power countered the argument that the private sector has to bear part of the adjustment burden by noting that &the private sector has already shed 90,000 jobs.8 He stressed that the government

and the public need to realize that Ireland cannot be reliant on just the domestic market and that the country needs to re-focus on exports as the road to recovery.

Comment

¶9. (C) In dealing with Ireland's economic problems, the job is not finished on April 7. The government will likely lay out a longer-term plan that will explain how it expects to get the budget deficit down to around three percent of GDP by 2013, as agreed with the EU. The recommendations from the Commission on Taxation and a group of "wise persons" looking at ways to reform government spending will both be key to this fiscal policy transformation. Politically, as McDowell and others have pointed out, the Fianna Fail/Green Party coalition government - which holds a slim majority right now - may edge closer to collapse if the more unpopular measures in the budget cause too much political heartburn for Fianna Fail backbenchers in their constituencies. We will be watching the political fallout from the budget closely.
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